

Internal Revenue Service
memorandum

CC:TL-N-2754-90

JCAlbro

date: APR 11 1990

to: Regional Counsel, Southwest CC:SW
Attn: International Special Trial Attorney

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED], Tax Court Dkt. No.

This is in response to your request for tax litigation advice dated January 11, 1990, involving section 163 deductions for interest on alleged uncontested tax deficiencies.

ISSUE

Whether, for each of the taxable years [REDACTED] through [REDACTED], inclusive, [REDACTED], an accrual basis taxpayer, is entitled to deduct interest on alleged uncontested deficiencies in federal income taxes arising due to adjustments made by the District Director to [REDACTED] federal income tax liabilities for each of the taxable years [REDACTED] through [REDACTED], inclusive?

CONCLUSION

We believe that [REDACTED] may not deduct the interest on the alleged uncontested tax deficiencies until the taxable year that deficiencies are asserted and agreed to by the taxpayer. The execution of a Form 870 or equivalent document would constitute taxpayer's agreement. Furthermore, prior to a final determination of the tax deficiencies for the years in issue, the interest liability is a mere probability not a fixed liability. See Rev. Rul. 70-560, 1970-2 C.B. 37; TAM 82-10-019 (November 27, 1981).

FACTS

[REDACTED] and its affiliated corporations filed consolidated corporate income tax returns for taxable years [REDACTED] through [REDACTED] and subsequently have filed a number of claims and/or amended returns. Each of [REDACTED] returns for [REDACTED] through [REDACTED] were examined by the Service. [REDACTED] formally protested some, but not all of the issues, for each of these years. With the exception of closing agreements and the ITC adjustment on [REDACTED] for [REDACTED] and [REDACTED], there are no

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written agreements (closing agreements or Forms 870 or 870 AD) executed by [REDACTED] during the years [REDACTED] through [REDACTED] to signify agreement to any of the uncontested adjustments. [REDACTED] contends that it was understood that unprotested adjustments were conceded. In at least one instance, it appears that if all protested or contested issues had been resolved in [REDACTED] favor, an overpayment would have resulted for that particular year.

[REDACTED] alleges that it is entitled to deduct interest expense accrued in taxable years [REDACTED] through [REDACTED] with respect to the unprotested adjustments for all of the taxable years at issue. Taxpayer apparently believes that its protest to the revenue agent's report filed in [REDACTED], which omitted protesting certain issues, fixed its liability for interest on the "uncontested" portion of the deficiencies covered by that report. The timing of interest deductions in years subsequent to [REDACTED] is apparently related to additional protests which also omit certain "uncontested" issues.

On [REDACTED] [REDACTED] received a notice of proposed deficiency (30 day letter) and a revenue agent's report (RAR) for taxable years [REDACTED] through [REDACTED]. The 30 day letter and RAR for [REDACTED] was received on [REDACTED], for [REDACTED] on [REDACTED], for [REDACTED] and [REDACTED] on [REDACTED] and for [REDACTED] and [REDACTED] on [REDACTED].

The Revenue Agent's transmittal letter, Form 866-A, for [REDACTED] and [REDACTED] states [REDACTED] wanted "to keep all of their options open by not making a commitment to agree to any adjustment for [REDACTED] or [REDACTED]" (except the previously mentioned agreements involving [REDACTED]). In [REDACTED], [REDACTED] and the Service executed a Form 870 AD in which [REDACTED] conceded the uncontested issues for the years in issue.

DISCUSSION

I. I.R.C. § 461(f).

An accrual basis taxpayer may deduct an expense in the taxable year in which all the events have occurred to determine the fact of the liability and the amount can be determined with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2). Contingent liabilities, such as liabilities which are contested by the taxpayer, are not deductible until the contest is resolved. See Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944). Section 461(f) was added to the Code in 1964 because Congress believed that it was unfair to deny taxpayers a deduction where payment has been made, even though the liability was still being contested. Thus, section 461(f) permits taxpayers to deduct a liability, even if contested, if a transfer of money or other property is made in the tax year to provide for satisfaction of the asserted liability and if the all events test is otherwise

met. Treas. Reg. § 1.461-2(a)(1).

Therefore, section 461(f) provides an exception to the timing of deductions for contested liabilities where payment has been made and the all events test is met. [REDACTED] may not take a deduction pursuant to section 461(f) because payment has not been made.

II. Section 163 indebtedness.

Treas. Reg. § 1.163-1(a) allows a deduction, under certain factual circumstances not in issue here, for interest paid or accrued on indebtedness. Indebtedness means an existing, unconditional and legally enforceable obligation for the payment of money. First National Company v. Commissioner, 289 F.2d 861, 865 (6th Cir., 1961). We have considered the applicability of Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944), to the instant issue. You have indicated that the Appeals Officer believes that Dixie Pine presents litigation hazards.

Dixie Pine established that where a liability is contested and thus contingent, a deduction may not be claimed until the taxable year in which the contest is resolved, and in the case of Dixie Pine, that meant not until final adjudication of state court litigation. [REDACTED], of course, places primary emphasis on the fact that they have not formally contested various deficiencies upon which they have accrued interest deductions. We assume that they would argue, pursuant to Dixie Pine, that where a liability is not contested, it may be deducted. An important distinction, though, is that there must be an indebtedness, a fixed liability. The liability at issue in Dixie Pine was a tax which had been assessed against the taxpayer. Id. at 517. There was a fixed liability, an indebtedness, and the fact that the liability was contested was the sole reason that the deduction was disallowed. Thus, the first question in this case is whether there is a contest and secondly, whether there is a fixed liability or indebtedness pursuant to section 163.

Treas. Reg. § 1.461-2(b)(2) provides that any contest that would prevent accrual of a liability under section 461(a) shall be considered to be a contest. A contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. It is not necessary to institute suit in a court in order to contest an asserted liability. An affirmative act denying the validity or accuracy, or both, of an asserted liability to the person who is asserting the liability, such as including a written protest with payment of the asserted liability, is sufficient to commence a contest. Whether a contest exists is based upon an evaluation of all the facts and circumstances. Treas. Reg. § 1.461-2(b)(2). Although [REDACTED] specifically protested only some of the issues raised in

the examination reports, we do not agree that the "unprotested" issues are clearly uncontested issues. We believe that the facts and circumstances in this case, such as taxpayer's refusal to sign formal agreements to the alleged conceded deficiencies, arguably represent affirmative denial of a potential liability. Alternatively, we note that there is not a contest because there is not even an asserted liability within the meaning of section 461(f). See Rev. Rul. 89-6, 1989-1 C.B. 119 (a notice of proposed deficiency accompanied by a revenue agent's report is an asserted liability). As discussed, *infra*, the all events test is not met for the deduction of an uncontested liability.

The Appeals Manual, CCDM (8000)8(21)32.1 discusses waived issues and provides that issues which have not been protested need not be mentioned in the Appeals Supporting Statement. Yet, of course, such "unprotested issues" could always be raised by the taxpayer during the appeals administrative process. Thus, [REDACTED] had not waived ever raising these issues. They kept all options open to them. We also believe that the taxpayer's specific refusal to execute Form 870's or closing agreements for taxable years [REDACTED] and [REDACTED] supports classifying the issues as not conceded.

The court in Commissioner v. Fifth Ave. Coach Lines, 281 F.2d 556 (2d Cir. 1960) cert. denied, 366 U.S. 964 (1961), was faced with a somewhat analogous situation in that taxpayer sought an interest deduction for a tax deficiency but had not formally acquiesced in the determination of the tax liability. The Second Circuit reversed the Tax Court's allowance of an accrued deduction for interest on tax deficiencies. The Tax Court concluded that the interest liability was substantially fixed and unconditional in the year of the earlier court decision (and year of the accrued deduction) so that accrual was justified. The Second Circuit stated that a taxpayer may not accrue an interest deduction prior to termination of the right to appeal. The Tax Court relied on taxpayer's assertion that company officers did not contemplate appealing. The Second Circuit held that the interest liability was not fixed because a right to appeal the Tax Court decision existed until the year following the accrued deduction. The court noted, *id.* at 559, that a taxpayer desiring an earlier deduction may relinquish the right to appeal at any time by notifying the Commissioner of acquiescence. The court further pointed out the complexities involved in determining the reasonableness of an expectation of appeal. In this case, too, we are concerned with whether there is a fixed indebtedness. The taxpayer says there is no contest or protest, but refused to concede the issues until [REDACTED]. Taxpayer's equivocal position on the underlying anticipated deficiencies is inconsistent with its position that an interest indebtedness exists. The indebtedness is contingent prior to a final determination of the deficiencies or a formal agreement to the deficiencies. Even assuming the anticipated deficiencies are unprotested, under the facts of this

case, there is no expense (no interest indebtedness) to deduct.

At issue in Arheit v. Commissioner, 31 T.C. 46 (1958) was the disallowance of an interest deduction claimed by taxpayer for payments made prior to any formal determinations or assessments of deficiencies. Taxpayer's estimate of deficiencies was based upon information received informally from revenue agents. The court held that an indebtedness had not been definitively established in 1952, the year in which taxpayer sought a deduction for interest paid. In 1952, no formal determination of liability for additional taxes had been made, nor had the taxpayer entered into any agreement establishing his liability for additional taxes. Taxpayer argued that he had admitted that he owed deficiencies in a letter to the Commissioner, but the court held that even construing the letter to mean an offer to accept liability for taxes, such offer was not accepted by the Commissioner nor did the facts establish that the taxpayer had formally acquiesced in any proposed deficiencies. The court noted that by not making a definitive determination in 1952 of additional tax liabilities, the Commissioner could revise the then proposed deficiencies upward or downward. In 1955, a notice of proposed deficiency (30 day letter) was sent, and subsequently taxpayer entered into a settlement with the Commissioner by executing Forms 870. The court stated that formal notices of proposed deficiencies were not sent until 1955, nor was there a settlement of petitioner's liability for additional taxes establishing indebtedness until 1955. Id. at 55.

Similarly, in Shubert v. Commissioner, 41 T.C. 243 (1963), at the end of 1955, a final revenue agent's report had not been completed nor had taxpayer entered into any agreement regarding additional taxes and interest. The liability for interest on the deficiency was fixed in 1956 when the final examination report was issued and taxpayer signed a Form 870. These cases establish that there is no indebtedness for an interest deduction on tax deficiencies prior to a final determination on the tax liability at issue. In both cases, the interest deduction was held allowable in the year taxpayers signed Form 870.

We believe that under the facts of this case the indebtedness is contingent prior to the execution of an agreement to a tax liability. An interest deduction pursuant to section 163 is not allowable when an advance payment designated as interest is made on an "anticipated deficiency". Therefore, an accrued deduction (no payment made) is clearly not allowable with respect to an anticipated deficiency. Revenue Procedure 84-58, O.M. 20,006, I-030-86 (May 15, 1986).

Rev. Rul. 89-6, 1989-1 C.B. 119 involves interest paid on a contested tax liability and analyzes whether the requirements of sections 163 and 461(f) are met for a deduction in the tax year of a payment not designated as a deposit. Rev. Proc. 84-58,

1984-2 C.B. 501 sets out the procedures for remitting payments in order to stop the running of interest on deficiencies. In the special circumstances of a contest, where section 461(f) is applicable, Rev. Rul. 89-6 establishes that a notice of proposed deficiency (30 day letter) accompanied by a revenue agent's report (RAR) constitutes assertion of a liability pursuant to section 461(f). Rev. Rul. 89-6 also states that pursuant to Rev. Proc. 84-58, the Service will no longer follow the court's conclusion in Leich v. United States, 329 F.2d 649 (Ct. C. 1964) that, in the absence of a tax assessment, an amount proposed in a revenue agent's report is not an asserted liability within the meaning of section 461(f).

In summary, Rev. Rul. 89-6 establishes the circumstances, pursuant to Rev. Proc. 84-58, that interest remittances may be deductible where payment is made subsequent to a notice of proposed deficiency (30 day letter) accompanied by an RAR, and the taxpayer is contesting the proposed tax and related interest. An asserted liability for purposes of section 461(f) and what constitutes a deductible payment of tax and interest pursuant to Rev. Proc. 84-58 and Rev. Rul. 89-6 is distinguishable from what constitutes a section 163 indebtedness and a fixed liability for accruing interest deductions which have not been paid.

III. All Events Test

In addition to arguing that there is no indebtedness, a related argument is that the all events test has not been met for the interest deductions. Treas. Reg. § 1.461-1(a)(2) provides that under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. If the existence of the liability is subject to any conditions precedent, contingencies, or other circumstances, which prevent the taxpayer from having a recognized, acknowledged, and existing liability, deduction is premature. Determination of the fact of liability must be made on the basis of facts actually known or reasonably knowable as of the close of the year. See generally United States v. Hughes Properties, Inc., 476 U.S. 593 (1986). The Supreme Court stated in United States v. General Dynamics Corp., 481 U.S. 239 (1987), that although expenses may be deductible before they have become due and payable, liability must first be firmly established. Taxpayers may not deduct contingent liabilities nor may they deduct estimates of anticipated expenses, no matter how statistically certain, if based on events that have not occurred by the close of the taxable year. Id. at 243. At the end of each of the years in issues, the alleged interest due was based on anticipated deficiencies, and taxpayers had not formally agreed to such deficiencies. Interest was thus accrued on contingent liabilities.

Rev. Rul. 70-560, 1970-2 C.B. 37 holds that interest on a tax deficiency, whether contested or not, should be accrued and deducted in the year the liability for the deficiency is finally determined. In the case of a deficiency contested in Tax Court, final determination occurred in the year that the court decision was final. If the tax deficiency had not been contested, and taxpayer agreed to the deficiency when asserted, interest accrued and was deductible in the taxable year of the assertion and agreement. Rev. Rul. 70-560 establishes that a final determination includes a final court adjudication as well as an executed agreement by taxpayer to a deficiency. See also Tax Notes (March 26, 1990), copy attached, quoting Kenneth Klein, Associate Chief Counsel (Technical) in which he noted in a recent speech that there is an apparent conflict between Rev. Rul. 70-560 and GCM 38,172, see infra (as well as two similar GCM's) but that Rev. Rul. 70-560 represents the only published guidance on which taxpayers could rely.

As you noted in your request for advice, there is a technical advice memorandum closely on point to your case, TAM 82-10-019 (November 27, 1981). Taxpayer orally conceded certain proposed adjustments to its federal income tax return, protested the remainder, and refused to execute a Form 870. Taxpayer argued that since it had conceded certain proposed adjustments, all the events had occurred to determine the fact of liability for interest expenses related to such deficiencies. Relying principally on Rev. Rul. 70-560, the ruling holds that there must be a binding agreement (such as a Form 870) between the taxpayer and the Service in which taxpayer agrees to the proposed adjustments and/or waives restriction on assessment and collection of the deficiency. The TAM notes that taxpayer cannot have it both ways--refuse to execute Form 870 (delaying assessment) and also "agree" to the proposed adjustments in order to accrue interest expense. The TAM concludes that for accrual of interest to take place prior to assessment, there must be an established liability. All the events had not occurred which would determine the fact of liability for the interest expense at issue. The TAM also noted the practical difficulty in determining when a taxpayer agrees to a proposed adjustment. See also Globe Products Corp. v. Commissioner, 72 T.C. 609 (1979) (taxpayer may accrue and deduct interest on its portion of uncontested deficiencies in the taxable year deficiencies established by a stipulated decision); Rose v. United States, 256 F.2d 223 (3rd Cir. 1958) (interest on estate tax deficiency accrued and deductible for federal tax purposes in year settlement agreement accepted by both parties).

You have requested that we consider the case of Hollingsworth v. United States, 568 F.2d 192 (Ct. Cl. 1977). This case involved the so-called relation back doctrine; that is, where an additional tax liability for a prior year is asserted by the Service, and that liability is not contingent and contested,

all events necessary to determine the fact and the amount of liability are deemed to have occurred in the year to which the liability relates, notwithstanding the taxpayer's failure to acknowledge the liability in the prior year. In Hollingworth at 198, it states that the Service conceded that unless the state income tax deficiencies, and interest on state and federal income tax deficiencies, (which plaintiff claimed the right to accrue as deductions in earlier years) represented contested liabilities, they are deductible in determining taxable income for the earlier years. Yet, Service position is that interest on federal tax deficiencies does not relate back. See Rev. Rul. 70-560 (interest on an uncontested deficiency in federal income taxes is accruable in the year the deficiency was asserted and agreed to by taxpayer). The Service has accepted the relation back doctrine for state taxes. See Rev. Rul. 68-631, 1968-2 C.B. 198 (additional state taxes subsequently found to be due upon audit will be deemed for Federal income tax purposes to relate back to the year for which the taxes were originally imposed; that is, uncontested state tax deficiencies accrue and are deductible for the taxable year for which the tax is imposed).

The issue of interest deductions on tax deficiencies has been the subject of repeated consideration in the National Office, but many proposed positions have never been approved. For example, the G.C.M. mentioned Mr. Klein's speech, [REDACTED] G.C.M. 38,172, I-240-73 (November 15, 1979), considered a proposed revenue ruling (never published) to modify Rev. Rul. 70-560 to hold that interest on uncontested federal tax deficiencies accrued ratably commencing with the date the tax was due or in other words, allowing the relation back of a deduction for the accrued interest to the date the tax was due. The Service's historical rejection of the relation back doctrine, at least with respect to interest on federal tax deficiencies, is based on administrative reasons. It is argued that in a typical multi-year situation, problems would arise because interest income or deductions would be created retroactively in tax years subsequent to the year of an underlying adjustment. Many amended returns for relatively small amounts would be required; interest income and deductions would arise in time-barred years; and a feedback problem requiring an algebraic solution could arise because, for example, an additional interest deduction would create an overpayment, which would itself bear interest, which in turn would create an underpayment, etc.

In summary, we believe that until taxpayer's formal concession in [REDACTED], there is a reasonable argument that a contest or at least unagreed issues existed due to the specific refusal to execute a formal agreement to the deficiencies. Although only certain issues were formally protested, any other issues could have been raised during the administrative process. Because of the inherent ambiguity in taxpayer's position on the deficiencies, we do not agree with taxpayer that the issues were

unprotested or uncontested. Even assuming the issues were uncontested, under the facts of this case, no indebtedness exists for the years in issue, nor has the all events test been met for the interest deductions prior to the execution of a Form 870 or equivalent document.

We believe that the alleged indebtedness for interest on tax deficiencies in this case is contingent and that all the events have not occurred to fix a liability for interest on deficiencies under section 461 until the execution of a Form 870 or equivalent agreement. Therefore, the interest deductions at issue may not be accrued until the taxable year in which taxpayer formally agrees to the related deficiencies, and of course, does not contest the liability within the meaning of section 461(f).

The earliest date that an asserted liability existed for purposes of either section 461(f) or for purposes of an assertion and an agreement pursuant to Rev. Rul. 70-560, was [REDACTED], when [REDACTED] received a notice of proposed deficiency for taxable years [REDACTED] through [REDACTED].

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Attachment:
Tax Notes [REDACTED]